

TEACHERS ' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation

ITEM NUMBER: 7b

ATTACHMENT(S): 1

ACTION: X

DATE OF MEETING: September 3, 1998

INFORMATION:

PRESENTER: Ms. DuCray-Morrill

Attached is a comprehensive report from Hogan & Hartson on issues at the federal level. Ms. DuCray-Morrill will provide a verbal presentation at the meeting.

MEMORANDUM FOR THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

Congress has recessed and pushed off until September the bulk of its serious work on budget, tax, and appropriations legislation -- including the legislation that is necessary to keep the Federal government operating in the new fiscal year that begins October 1. The Senate returns to session on August 31, and the House returns on September 9, providing just about a month to delve through this mountain of legislative work.

Mandatory Social Security

The near term aim of the coalition of State and local government groups fighting mandatory coverage continues to be establishing and mobilizing a strong grassroots network of State and local government groups, employers, employees, and public officials in key States. Coalition members are fanning out in their respective States to educate employers and employees about the adverse impacts of mandatory coverage on existing retirement plans and budgets.

To support STRS in this education effort, we have been working with STRS staff to prepare briefing materials tailored to employers and employee groups. The basic theme to both employers and employees is that under mandatory coverage State and local governments -- such as California, which has prefunded the STRS teacher retirement program to pay out almost \$3 billion in benefits each year -- would be asked to cast aside decades of successfully providing retirement benefits to generations of workers, in order to force the future membership into a pay-as-you-go Social Security system providing reduced benefits at higher cost. All of this cost and disruption would be imposed to solve a Federal problem that these State and local governments had no hand in creating.

The briefing materials for employers underscore the harsh impact that mandatory Social Security would have on school district budgets in terms of additional payroll taxes and added retirement plan costs simply to continue to provide the same overall level of benefits. In addition, employers would lose critical flexibility to manage retirement costs under the "one-size-fits-all" approach of Social Security determined in Washington.

The focus in briefing employees is on the impact that these added cost burdens will have on benefit levels. Actuarial studies done for STRS indicate that it would cost an additional three to six percent of payroll to fund a supplemental retirement tier which when combined with Social Security equates to the retirement benefits currently provided by STRS. These cost pressures are likely to translate into pressures for benefit cuts. In addition, the new State and local workers would be mandated into a Social Security system under which they concededly would be expected to receive less in Social Security benefits than they contribute.

Further, the employee groups will lose important leverage in the setting of benefits under the "one-size-fits-all" approach of Social Security determined in Washington.

At the Washington end, we are coordinating with PERS on a briefing on the mandatory coverage issue for the California Congressional delegation, now scheduled for September 10 on Capitol Hill. We are working with STRS staff on this.

The time for grassroots action is now. Competing Social Security reform plans already are being put together by Republicans and Democrats with an eye toward post-November election period negotiations between Congress and the Administration. The reform plans put on the table thus far by both Republicans and Democrats (described in previous Monthly Reports) have included a mandatory coverage provision. Both Republican and Democratic "reformers" sorely need the near-term revenue pick-up from mandatory coverage to help finance their respective visions of the route to Social Security solvency.

If comprehensive Social Security reform legislation comes together, it could well consist of a package of smaller "haircuts" (e.g., raising the retirement age by several years) which spread the "pain" out fairly widely, coupled with some limited use of private accounts. Once a mandatory coverage provision is in such an omnibus package, it will be hard to get out. The objective is not to be included in such a comprehensive package in the first instance.

The next three to six months leading up to the November elections and the aftermath until Congress returns in January constitute the crucial period for vigorous grassroots efforts on the mandatory coverage issue.

Our sense at this juncture is that unless State and local government employers, employee groups, and prominent public officials in the non-Social Security States collectively mount a vigorous grassroots opposition effort over the next three to six months and beyond, any Social Security reform legislation adopted within the next 12 to 18 months likely will include mandatory coverage for all new State and local workers.

Elk Hills Compensation

The House-Senate Conference seeking to resolve the differences between the House and Senate versions of the Defense Authorization Act broke off just prior to the August Congressional recess, with the two sides reportedly still far apart on various key issues. As reported previously, the House version of the Defense Authorization Act would eliminate the appropriation requirement for payment of the \$320 million in Elk Hills compensation to the State under the schedule set out in the settlement agreement.

Sen. John McCain (R-Ariz.) -- who had first suggested the escrow and settlement approach in the original legislation and had insisted that payment from the escrow fund be subject to an appropriation -- has reemerged as our principal antagonist in the Conference, reasserting control as the Senate negotiator on the Elk Hills provision. Senator McCain has continued to insist on the appropriations requirement. The House negotiators have continued to side with Rep. Bill Thomas (R-Bakersfield), our champion, in support of the House provision striking the appropriation requirement from the statute. Negotiations on

the Elk Hills issue had reached something of an impasse before the entire Conference broke down over broader disagreements. We are continuing to work with Rep. Thomas to explore possible avenues for resolving the issue when the Conference resumes upon Congress's return in September.

Governor Wilson has written a strong letter of support to his former Senate colleagues, urging that the Elk Hills compensation be paid to the State (copy attached). A call from Governor Wilson to Senator McCain also would be very valuable. We now have letters of support from the Governor, the State Attorney General, and the entire California Congressional delegation. In addition, we have gotten the White House senior staff involved to try to free up the funds, with the matter having been bucked up internally to the level of the Deputy Chief of Staff to the President.

Federal Legislation to Liberalize Pension Limits and Portability -- Impact on STRS

Several Members of the Senate Finance Committee on July 21 followed their House Ways and Means counterparts in introducing bipartisan legislation to enhance pension portability among various types of governmental retirement plans. The House legislation also would liberalize a series of current law limits on benefits under a defined benefit plan such as STRS (as well as liberalizing various contribution limits for defined contribution plans).

In the House, the bipartisan legislation is H.R. 3788, co-sponsored by Reps. Rob Portman (R-Ohio) and Ben Cardin (D-MD), the traditional champions of pension simplification on the House Ways and Means Committee and the same team that spearheaded our provision on nondiscrimination. In addition, Rep. Earl Pomeroy had earlier introduced stand-alone legislation dealing with pension portability among governmental plans (H.R. 3503) that is generally similar to the Portman-Cardin portability provisions.

A bipartisan group of Senate Finance Committee Members, led by Sens. Bob Graham (D-Fla.) and Charles Grassley (R-Iowa), has introduced a similar, but somewhat narrower, pension package in the Senate (S. 2339). The Senate package includes the governmental plan portability provisions, but does not include the more costly liberalization of the current law limits on benefits and contributions.

Pension Portability Among Governmental Plans

There are three portability provisions of interest to STRS in the House and the Senate bills: (1) permitting rollovers between governmental tax-qualified plans and section 403(b) arrangements and section 457 plans for the first time; (2) permitting direct trustee-to-trustee transfers (including in-service transfers) from section 403(b) arrangements and section 457 plans in order to purchase permissive service credit under governmental defined benefit plans; and (3) permitting the rollover of after-tax contributions.

1. Rollovers among governmental qualified plans, section 403(b) arrangements, and section 457 plans (H.R. 3788, sec. 301; S. 2339, sec. 301)

Under current law, rollovers are permitted between tax-qualified defined benefit and defined contribution plans. Section 403(b) distributions may be rolled only to another section 403(b) arrangement or to an Individual Retirement Account (IRA). Amounts may not be rolled into or out of a section 457 plan.

Both H.R. 3788 and S. 2339 would now broadly permit the rollover of "eligible rollover distributions" (as determined under the current law rules) between section 401(a) defined benefit plans, section 401(a) defined contribution plans, section 403(b) arrangements, section 457 deferred compensation plans maintained by a State or local government, or IRAs.

As a defined benefit plan, STRS would be permitted -- but would not be required -- to accept inbound rollovers from other defined benefit plans, defined contribution plans, section 403(b) arrangements, or section 457 plans.

2. Use of sec. 403(b) or sec. 457 account balances to purchase service credit in a governmental defined benefit plan (H.R. 3788, sec. 306; S. 2339, sec. 306)

Both H.R. 3788 and S. 2339 would permit the use of a direct trustee-to-trustee transfer from a section 403(b) arrangement or a section 457 plan to purchase permissive service credit or to redeposit a previous refund under a governmental defined benefit plan. The provision is intended to permit these transfers to be made on an in-service basis so that a State or local employee could make a transfer from a section 403(b) arrangement or a section 457 plan maintained by the same employer to purchase credit under a defined benefit plan such as STRS in which that employer participates. (An employer separating from service with another governmental employer could use the rollover mechanism to purchase service credit if the defined benefit plan of the new governmental employer accepts inbound rollovers for that purpose.)

Permissive service credit for this purpose would be defined by reference to the changes adopted last year in section 415(n) regarding the purchase of permissive service credit under governmental defined benefit plans.

Again, as with the rollover provisions, STRS would not be bound to accept such a trustee-to-trustee transfer from a section 403(b) arrangement or a section 457 plan for the purchase of permissive service credit or of a redeposit of contributions previously refunded under the STRS plan. The proposed statutory change simply would remove the adverse tax consequence to the participant of such a transfer from the section 403(b) arrangement or section 457 plan.

**3. Rollovers of after-tax contributions
(H.R. 3788, sec. 303; S. 2339, sec. 303)**

Both H.R. 3788 and S. 2339 would permit the rollover of after-tax contributions, now barred under the current law rollover rules. The rollover of after-tax contributions would be applied following the proposed liberalizing discussed above of the rules regarding the types of plans that may make or receive rollovers.

**Liberalized Benefit Limits Under Defined Benefit Plans
(H.R. 2788, sec. 101)**

H.R. 2788 only would liberalize various of the current law limits on the accrual of benefits under a defined benefit plan:

- The current law "dollar limit" under sec. 415(b) of \$130,000 would be increased to \$140,000 (subject to indexing).
- As under current law, actuarial reduction in the dollar limit would be required for governmental plans for benefits that commence prior to age 62, but a new floor of \$100,000 (indexed) at age 55 would be imposed on actuarial reductions in the dollar limit.
- The section 401(a)(17) limit on the amount of compensation taken into account in computing benefits would be increased to \$235,000, with future indexation of the limit in \$5,000 increments.

**Liberalized Contribution Limits Under
Defined Contribution Plans (H.R. 2788, secs. 101, 512)**

Similarly, H.R. 2788 only would liberalize various current law limits on contributions under defined contribution plans

- The section 415(c) limit on contributions to 25 percent of compensation would be increased to 100 percent of compensation for defined contribution plans generally.
- The section 415(c) dollar limit on contributions would be increased from \$30,000 to \$45,000, subject to indexing in \$1,000 increments.
- The maximum exclusion allowance under section 403(b) arrangements would be repealed, making such arrangements subject to the liberalized general section 415(c) limit.
- The overall annual limit on elective deferral under section 402(g) (applicable to section 401(k) plans and section 403(b) arrangements) would be increased to \$15,000.

**Liberalized Annual Deferral Limits for
Section 457 Plans (H.R. 2788, secs. 101, 108)**

H.R. 2788 also would liberalize the section 457 deferral limits::

- The annual limit on elective deferrals under a section 457 plan would be increased to \$15,000 (or \$30,000 in each of the last three years prior to retirement).
- The annual section 457 limit would no longer be reduced by elective deferrals under section 403(b) or other types of arrangements.

“Catch-Up” Contributions (H.R. 3788, sec. 201)

H.R. 2788 only would:

- permit individuals aged 50 or older to make an additional \$5,000 per year contribution to a section 403(b), section 457, or section 401(k) plan.
- permit participants in a section 457 plan to make annual contributions of \$30,000 (rather than the current law \$15,000) to the plan in each of the three years preceding retirement.

**Modify Sec. 403(b) to Reflect Repeal of Combined Defined Benefit-
Defined Contribution Limit Under Sec. 415(e)
(H.R. 3788, sec. 512; S. 2339, sec. 605)**

Outlook

The prospects are uncertain for enactment this year of a broad enough tax package that could incorporate these proposed changes. The portability provisions are likely to have a much more modest cost than the increased benefit and contribution limitations and hence could be a stronger candidate for enactment if such a broad tax legislative vehicle appears and if the House and Senate sponsors of the overall pension legislation are amenable to having pieces of their package move separately.

John S. Stanton

Attachment
August 12, 1998